The Impact of College Financial Aid Rules on Household Portfolio Choice

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Abstract

Households who save in anticipation of their child's college expenses reduce their child's eligibility for financial aid. The penalty of reduced financial aid eligibility acts as an implicit tax on household assets. At the same time, the federal algorithm used to compute the financial aid does not take into consideration the assets accumulated in retirement accounts or as home equity. Households can diminish their marginal financial aid tax rates by moving funds into retirement accounts or by increasing their home equity. Using the 2001 Survey of Consumer Finances, this study investigates the effect of the college financial aid rules on household portfolio choices. Our empirical analysis controls for the marginal income tax rates since investing in retirement accounts and having a home mortgage also have federal income tax benefits. Our results show that households who have higher marginal financial aid tax rates have higher retirement assets and home equity compared to their taxable financial assets. However, the marginal financial aid tax rate does not have a significant adverse effect on the amount of taxable financial assets.

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